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IN THE

Supreme Court of the United States

OCTOBER TERM, 1943.

No. 458.

NATIONAL SECURITIES CORPORATION,
Successor by Merger to
AMERICAN GAS & ELECTRIC SECURITIES CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF AMICI CURIAE.

ROBERT STERLING,
IRVING M. ENGEL,
Amici Curiae.

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BRIEF AMICI CURIAE.

I.

Preliminary Statement.

Counsel *Amici Curiae,* with the consent of the parties, respectfully submit this brief and request that the writ of certiorari sought by the petitioner, National Securities Corporation, be granted.

The citation to the opinion below, the reference to the jurisdiction of this Court and the statement of the case are set forth in the Petition for the Writ of Certiorari and are not repeated herein.

II.

Questions Involved.

A. Does Section 45 of the Revenue Act of 1936 authorize the Commissioner of Internal Revenue to limit deduction of loss by departing from the basis applicable under Section 113 (a) (8), where the property, when transferred in a transaction within Section 112 (b) (5), had a cost in excess of its then value, solely because of the shifting of economic burden thereby effected?

B. If Section 45 may be so applied, is that statute then so arbitrary as to violate the Fifth Amendment to the Constitution?

III.

Summary of Argument.

Section 45 of the Revenue Act of 1936 empowers the Commissioner of Internal Revenue to reallocate items affecting taxable income, in the case of related corporations, to prevent "evasion" of taxes and where necessary "clearly to reflect the income". The facts of this case, as well as the determination of the Commissioner and the opinions of the Board of Tax Appeals and the Circuit Court of Appeals, clearly eliminate "evasion" in the meaning that term ordinarily takes. Nor was there any finding of an intent to "avoid" taxes. However, the Circuit Court of Appeals appeared to sustain the Commissioner on the ground that the greater part of the loss

involved in the property transferred had already been sustained by the transferor and that an "artificial picture" would result if the loss were permitted to be shifted.

The provisions of Sections 112 and 113 of the Revenue Act of 1936, so far as they relate to corporate transactions, were evolved over many years of close study and much judicial scrutiny. As Congress had incorporated loss limitations in the provisions for determining basis as to gifts (and gifts in trust) after consideration of the identical problem, it is clear that there was no intent on the part of Congress to limit losses computed under the basis provision of Section 113 (a) (8) and other like provisions of Section 113 (a), merely because there was a shifting of economic benefit or burden, without more. The action of the Commissioner in this case effects an unlegislated limitation on losses to transferees in such transactions, applied in the arbitrary discretion of the Commissioner. If Section 45 were to be held to grant power to the Commissioner to depart arbitrarily from the statute and without reference to standards laid down in the Act, the Section so construed would be unconstitutional, as in violation of the Fifth Amendment.

IV.

Argument.

A.

Section 45 of the Revenue Act of 1936 does not authorize the Commissioner of Internal Revenue to limit or allocate deduction of loss by departing from the basis applicable under Section 113 (a) (8), where the property, when transferred in transaction within Section 112 (b) (5), had a cost in excess of its then value, solely because of the shifting of economic burden thereby effected.

Section 45 of the Revenue Act of 1936 does not sustain the limitation or allocation by the Commissioner of the deduction claimed by taxpayer.

Section 45, as stated by the Circuit Court of Appeals, below, "Congress has conferred authority upon the Commissioner to allocate deductions 'if he determines' that such allocation 'is necessary'. This is a broad discretion, limited only in that the necessity must arise 'in order to prevent evasion of taxes or clearly to reflect the income.'"

This section involves two considerations:

(a) Meaning of the phrase "evasion of taxes" including particularly consideration of "avoidance".

(b) Meaning of the phrase "clearly to reflect the income".

(a) "Evasion" of taxes is ordinarily taken to mean an attempt to defeat taxes, which, if done willfully, carries with it criminal liability. Section 145 (b), Revenue Act of 1936.

There was no evidence in the Record of any such "evasion" of taxes, nor did the Commissioner of Internal Revenue, the Board of Tax Appeals or the Circuit Court of Appeals draw any inference or suggest or imply the existence thereof.

It was suggested very strongly by the Circuit Court of Appeals for the Second Circuit in *Asiatic Petroleum Co., Ltd.* v. *Commissioner*, 79 F. (2d) 234, 236, cert. den., 296 U. S. 645, 664, that "the phrase 'evasion of taxes' [in Sec. 45] is broad enough to include the avoidance of the realization for taxation of such a profit through its transfer to another branch of the same business enterprise in a way which only changes its place in the business set up." This definition is entirely too broad, in our opinion; certainly the facts of the *Asiatic* case did not require so broad a statement to arrive at the result attained. Even on the assumption that the definition is correct, there must be "avoidance" indicated.

The Commissioner's disallowance of the loss merely referred to Section 45, without more. The Findings of Fact of the Board of Tax Appeals in the instant case make no reference to an intent to avoid taxes. The Board's opinion would seem to indicate that the motive of taxpayer and its parent was immaterial, but then suggests that the petitioner as a business measure would not have transferred "over $73,000 of its own stock for $8,562.50" of securities received from its parent. Since the taxpayer was the wholly owned subsidiary of the parent, the disparity does not seem to rate much consideration.

The opinion of the Circuit Court of Appeals in turn suggests that the Commissioner was not bound to accept the petitioner's explanation as to motives. However, the Court's main thesis seemed to be that as most of the depreciation in value had already occurred while the par-

ent held the stock, an artificial picture would result on the shift of the loss to the subsidiary.

(b) The reference in Section 45 to action by the Commissioner "clearly to reflect the income" involves primarily a determination of what the Congress meant by "income"; it would not seem difficult to determine proper limits to the Commissioner's discretion.

The normal income tax imposed under the Revenue Act of 1936 was based on statutory "net income", Section 13; the surtax relating to undistributed profits was measured by an amount derived from the statutory "net income", Section 14. It has long been pointed out by this Court that deductions, for income taxes, depend on legislative grace. *New Colonial Ice Cream Co.* v. *Helvering*, 292 U. S. 435.

What did Congress have in mind with respect to the term "income" as used in Section 45? Was the intent there to refer to "net income" as a category established in the income tax law, *i. e.*, the "net income" of Sections 13 and 14? Or was the intent to refer to "net income" as used by the accountant or the economist or others? (Cf. Klein, *Federal Income Taxation*, pp. 46-47.)

Assume agreement that "income", as used in Section 45, applies to statutory "net income" for tax purposes. Then the Commissioner may not apply Section 45 to modify an exact computation of statutory "net income", if his sole action then is to reverse a shift, *obviously intended by Congress*, in economic benefit or burden.

The application of Section 45 is indicated without difficulty in other situations; *i. e.*, in the *Asiatic Petroleum Co.* case, *supra*, the taxpayer, which was subject to United States income taxes, sold property to its affiliate, not subject to such taxes, at cost, which was very substantially less than the sale price then immediately secured by the transferee. In *G. U. R. Co.* v. *Commissioner*, 117 F. (2d)

187, the taxpayer purchased from its affiliate at cost to the latter, which was very much above the fair market value at the time, and the Commissioner invoked Section 45 to disallow (as a loss) that excess on the occasion of sale by taxpayer. In neither of these cases did the statute contemplate or intend that the inter-company transfers take effect at other than the then fair market value of the property. But such was the intent of Congress in the instant case.

The early "reorganization" decisions of this Court, culminating in *Marr* v. *United States,* 268 U. S. 536, compelled recognition of gain and loss in corporate transactions which do not now result in such recognition, under Section 112. There was a deliberate departure by the Congress from these decisions, effected by Sections 112 and 113, which expressly contemplated and intended a shift in economic benefit or burden.

The statutory history of Section 113 (a) (8) is very clear and is set forth in the brief of the Petitioner for the Writ. Comparison may well be made with Section 113 (a) (2) and (3). It will be recalled that prior to the amendment of Section 113 (a) (2) effected in the Revenue Act of 1934, there was merely provision for persistence of basis with respect to *gifts* made after December 31, 1920. Section 113 (a) (2) of the Revenue Act of 1932 was amended by the Revenue Act of 1934 to provide that for the purpose of determining loss, the basis should be fair market value at the time of the gift or the basis as otherwise provided in the Section, whichever might be lower. Section 113 (a) (3), relating to *transfers in trust* after December 31, 1920, was not similarly amended in 1934. Upon this being brought home forcefully through the decisions in *Commissioner* v. *Warren Webster Trust No. 1,* 122 F. (2d) 916 (C. C. A.—3) and *Commissioner* v. *Title Guarantee & Trust Co.,* 123 F. (2d) 819 (C. C.

A.—2) the section was amended by Section 143 of the Revenue Act of 1942 to achieve the same limitation.

If the decision of the Circuit Court of Appeals in the instant case remains unreversed, the effect will be that the provisions of Section 113 (a) (8) (so far as transactions under Section 112 [b] [5] are concerned) may be relied upon only when the property has enhanced in value while owned by the stockholder and not in cases where there has been a reduction in value during that period. The broad and explicit language of the two sections just mentioned is applicable whether the asset has gained or lost value while owned by the stockholder. It is clear from the language of those two sections that Congress did not intend for two different rules to be applied. If, therefore, the provisions of Section 113 (a) (8) are to be made applicable only to the cases where the property has not lost value in the hands of the stockholder then that result must be accomplished by Act of Congress and not by arbitrary action on the part of the Commissioner under Section 45. The principle is, of course, of great importance, as it affects every loss not now limited by statute which results from the transfer of property in transactions coming within Sections 112 and 113.

B.

If Section 45 applies in the instant case, then it authorizes arbitrary and capricious action in violation of the Fifth Amendment.

The general rules for computation of taxable income are matters for the Congress. What did Congress have in mind with respect to the term "income" in Section 45? Was the intent to refer to a category established in the law, *i. e.*, the "net income" of Sections 13 and 14 of the Revenue Act of 1936, or was the intent to refer to "in

come" as used for accounting or economic purposes, or to provide for some other basic point of reference? If the first reference, that to "net income" as contemplated by the Revenue Act of 1936, limits the Commissioner, then the provision is clearly constitutional because it sets up known standards binding upon the Commissioner. However, if "income" as it appears in Section 45, may not be defined in terms within the statute, there is an absence of standards for the Commissioner to apply. In the latter case, the provision would be invalid. *Schechter* v. *United States,* 295 U. S. 495.

Counsel urge that when Congress permitted the Commissioner under Section 45 to take action where necessary "clearly to reflect the income", Congress had reference to standards laid down elsewhere in the Act. This means, with respect to those Sections of the Act which provide for deferment of recognition of gain or loss and for the persistence of basis, that their usual application should stand if the sole reason for departing therefrom would be the shift of economic benefit or burden effected by transactions within these Sections. For Congress clearly expected and contemplated such shifting of benefits or burdens.

If the Court below held that the mere shifting of economic benefit or burden was enough to give the Commissioner power to exercise the discretion delegated under Section 45, the Circuit Court was attributing to the Commissioner a power under Section 45 which was "arbitrary or capricious". The Court below has held, in effect, that the Commissioner may choose any other standard than that set up in the statute. Even if such new standard would not be arbitrary or capricious, if adopted by Congress, it remains arbitrary or capricious for the purposes of this case. If this be a sound conclusion, then Congress, as Chief Justice Hughes said in the *Schechter* case,

"by the failure to enact such standards, has attempted to transfer that function to others". In that view, as Mr. Justice Cardozo said in the same case, "The delegated power of legislation * * * is unconfined and vagrant".

CONCLUSION.

For the foregoing reasons, we respectfully submit that the petition for a Writ of Certiorari should be granted.

ROBERT STERLING,
IRVING M. ENGEL,
Amici Curiae.

V.

Appendix.

Revenue Act of 1934:

Sec. 113 (a) (2): "GIFTS AFTER DECEMBER 31, 1920.—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower. * * * "

Sec. 113 (a) (3): "TRANSFER IN TRUST AFTER DECEMBER 31, 1920.—If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a bequest or devise) the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer

under the law applicable to the year in which the transfer was made."

Revenue Act of 1932:

Sec. 113 (a) (2): "GIFT AFTER DECEMBER 31, 1920.—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by fift. * * * "

Revenue Act of 1942:

Sec. 143 (b): "Section 113 (a) (3) is amended to read as follows: 'TRANSFER IN TRUST AFTER DECEMBER 31, 1920.—If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made.' "